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SUBJECT: PAKISTAN LOAN STATUS REPORT - ADB AND WORLD BANK

11. (SBU) Summary: Although the media reported the Asian Development Bank (ADB) will disburse USD 500 million in budgetary support to the GOP by September 30, an ADB official informed the Embassy the loan remains contingent on an International Monetary Fund (IMF) comfort letter which the ADB has not yet received. In order for the initial ADB disbursement to occur by September 30, the ADB needs to receive the IMF letter by September 5. The Embassy's assessment is that the GOP now understands the gravity of the economic crisis. The rate of depletion of State Bank of Pakistan (SBP) foreign exchange reserves has decreased by approximately 33 percent in the two weeks ending August 22. However, in the absence of further bilateral and multilateral assistance, the economic reform measures the GOP is currently undertaking may be too little, too late. At the current rate of depletion of reserves, if the GOP does not move quickly to cut subsidies further and gain better control of government spending, the ADB loan will only postpone a balance of payments crisis for a month. Moreover, an ADB official has noted the status of a World Bank loan the GOP expects to receive is uncertain and may not be on the horizon in the short term. End Summary.

SEPTEMBER LOAN DISBURSEMENT POSSIBLE
BUT IMF COMFORT LETTER CRITICAL

12. (SBU) The August 31 edition of the Business Recorder reported the Asian Development Bank (ADB) will disburse before September 30 USD 500 million of a total USD 1.3 billion "Accelerating Economic Transformation Program" loan. In a September 1 conversation with EconOff, an ADB economist said the ADB is still awaiting an IMF comfort letter. When and if the ADB receives this letter, it will be circulated to the ADB Board, and there will be a three-week period for consideration. Thus, in theory, the disbursement can still occur by September 30, but the clock is ticking. Factoring in processing time, in order for disbursement to occur by the end of this month, the ADB needs to receive the IMF comfort letter by September 5.

DETAIL OF ADB PROGRAM

13. (SBU) The ADB told the Embassy that past economic growth in Pakistan has come through large fiscal, trade, and investment deficits; it has not been accompanied by structural changes necessary to support long-term growth. The ADB official noted their program is, in part, budgetary support but, unlike an IMF program, it is not aimed primarily at macroeconomic stabilization. Rather,

it is more medium- and long-term focused.

¶4. (SBU) According to our ADB interlocutor, the basic premise of this program is that Pakistan needs transformation in three main areas. The GOP, he said, must first address distortions in the economy, particularly in the energy and agricultural sectors. This will involve restructuring the pricing and procurement system for wheat, reforming electrical subsidies to resolve the circular debt issue, and better targeting subsidies so that they benefit the poorest and most vulnerable in society. Second, the Government needs to strengthen financial intermediation to facilitate structural transformation. Here, the GOP needs regulations aimed at promoting consumer confidence, more effective management of financial risks, and deepening financial intermediation. Third, the ADB believes that over the medium and long term, the production and trade structures must be transformed so that Pakistan can compete in the global economy. To do this, the ADB program will work to help Pakistan deepen its industrial base, make the agricultural sector more productive, make food processing more efficient, enable greater value creation in the service sector, develop greater export sophistication, and attract private sector investment.

¶5. (SBU) The ADB explained that the USD 500 million disbursement represents funding for the first or four subprograms that make up the "Accelerating Economic Transformation Program". These funds are to be used to establish targeted safety nets for the poor, increase wheat price support from Rupees 425 to Rupees 650 per 40 kilograms, and reduce electrical subsidies by Rupees 88 billion (USD 1.3 billion) in FY2008-09. They are also meant to strengthen financial intermediation by developing effective frameworks to regulate financial conglomerates and handle anti-money laundering activities,

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and establishing Real Time Gross Settlement for interbank transactions.

COMMENT

¶6. (SBU) State Bank of Pakistan (SBP) foreign exchange reserves decreased USD 381.8 million for the period August 8-August 15 and USD 254.7 million for the period August 15-August 22. Comparing the latter to the former period, the rate of depletion of reserves decreased by approximately 33 percent. Although this can in part be attributed to a decrease in world oil prices, GOP reform measures may be beginning to have a positive impact on the economy. Still, if the GOP does not move quickly to cut subsidies further and gain better control of government spending, the ADB loan would only postpone a balance of payments crisis by about a month. In addition to the ADB loan, the GOP is counting on a USD 500 million World Bank loan to help overcome the current financial crisis. According to the ADB, it is unclear whether the Bank intends to make the loan at this time. In ADB meetings with World Bank officials last week in Islamabad, the ADB told us the Bank was quite troubled by recent further deterioration of Pakistan's macroeconomic indicators and appeared somewhat reluctant to go forward with the loan at present.

¶7. (SBU) Comment Continued: From recent meetings the Ambassador has had with Finance Minister Qamar and other high ranking GOP officials, it is clear the GOP now understands the gravity of the economic situation. There are numerous stories in the Pakistani press everyday detailing GOP reform efforts. Indeed, in the September 1 edition of Dawn newspaper, the Prime Minister himself defended the removal of subsidies and noted the GOP is "taking bold decisions to phase out subsidies in order to rehabilitate the economy." Unfortunately however, in the absence of further bilateral and multilateral assistance, these steps may be too little, too late. End Comment.

PATTERSON